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This finally leads to the charge of "defeatism": I deny entirely that this term is applicable to a piece of analysis. Defeatism denotes a certain psychic state that has meaning only in reference to action. Facts in themselves and inferences from them can never be defeatist or the opposite, whatever that might be. The report that a given ship is sinking is not defeatist. Only the spirit in which this report is received can be defeatist: The crew can sit down and drink. But it can also rush to the pumps. If the men merely deny the report though it is carefully substantiated, then they are escapists... Frank presentation of ominous facts was never more necessary than it is today because we have developed escapism into a system of thought.

— Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, 1942

FRIGHTENING RISKS

Past recessions used to be the phase in the business cycle in which businesses and consumers, under the pressure of tight money, unwound their borrowing and spending excesses of the prior boom. In the same vein, the tight money created pent-up demand in business investment, housing and durable consumer goods that propelled the following recovery once the monetary reins were eased.

In the United States, nothing of the kind has happened this time. Instead, the U.S. economy "enjoyed" an unprecedented credit deluge, which drastically worsened the boom-related excesses and imbalances. Lacking the usual support from internally generated income growth, the consumer instead resorted to heavy "borrowing from the future." Domestic saving has been virtually eliminated.

Nevertheless, the consensus sticks to the view that better times for the economy and the markets are just around the corner. Keeping our eyes on the worsening imbalances and structural dislocations in the United States, all of them at the expense of saving and investment, we see a scenario unfolding that is radically different from this optimistic view.

In the third quarter of 2004 U.S. real GDP grew at a lower-than-expected 3.7% annual rate, as surges in both auto sales and defense spending were offset by sharply lower growth of residential and inventory investment. On the other hand, real GDP growth got a big boost from a mysterious steep decline in the recorded GDP price deflator from 3.1% to 1.1% at annual rate. The alleged main cause was a steep decline in energy prices. In the rest of the world, these prices rose steeply. Nominal U.S. GDP slowed from 6.6% to 5.1% at annual rate.

Apparently surprised and shocked by the trade deficit's relentless growth, U.S. policymakers and economists have suddenly grasped the idea that a declining dollar could go a long way in sparking the sorely needed rebalancing of both the U.S. economy and the world economy.

In our view, this is precisely the escapism that Joseph Schumpeter lamented in his example of the sinking ship quoted at the start of this letter. America's economy is suffering from a variety of savage imbalances that have eroded its growth dynamics. Its key structural problem is that unprecedented debt and consumption excesses have choked, rather than stimulated, business investment. It is utterly unrealistic to believe that a falling dollar will cure this gross misallocation of resources. Long, long ago, we learned that currency devaluations are only successful when associated with the measures that policymakers want to avoid.

EMPLOYMENT AND INCOME FIASCO

One consideration, in particular, has been determining our increasingly negative assessment of the U.S. economy's prospects. That is the manifest employment and income fiasco. The Bush administration called the tax cut package, which took effect in July 2003, its "Jobs and Growth Plan." The president's Council of Economic Advisers projected that it would result in the creation of 5.5 million jobs by the end of 2004. This would have implied 306,000 new jobs each month starting in July 2003.

Since the recession began 43 months ago, in March 2001, close to 500,000 jobs have disappeared from the U.S. economy. But this number is considerably beautified by substantial job gains in the public sector. In contrast, the private sector has suffered an overall job loss of more than 1.2 million. On closer look, however, the job destruction is massively centered in manufacturing. Since end-2000, jobs in this sector have plunged from 17.6 million to 14.4 million, representing an 18.2% loss. And mind you, this has happened within less than four years.

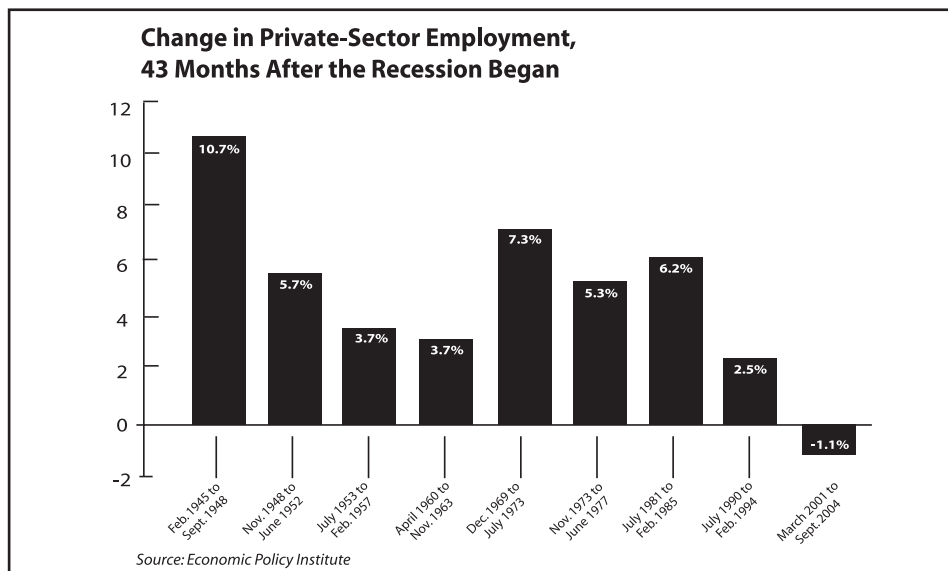
By focusing on the grossly distorted unemployment rate, most observers of the U.S. labor market completely fail to realize the severity of the development in this market and the associated loss of wage and salary incomes.

The reported rate is considerably understated because an unprecedented and growing number of unemployed people have given up on actively looking for a job. The Bureau of Labor Statistics admits, in its monthly employment survey, that these people automatically drop out of the unemployment measurement. What matters statistically for being registered as unemployed is not the fact of unemployment, but the active search for employment.

But to understand the severity of the situation in the U.S. labor market, there is yet another aggravating factor to consider: the continuous growth of the working-age population by 1.2%, or more than 2 million young people, per year.

For the economy to return to full employment, it is not enough to restore employment to its previous peak level. These 2 million newcomers per year must also be accommodated. This has never been lacking in postwar periods, until now. This time, the economy has even failed to regain jobs lost since the start of the recession.

We come to the worst part of the poor U.S. employment performance: the dismal growth of aggregate wage and salary income. Wage rates have continued to rise, but taking job losses, shorter working hours, a considerable shift from high-paying manufacturing jobs into low-paying temp work in services and rising inflation rates into account, overall wage and salary income in real terms remains below its December 2000 level.



In that month, U.S. workers and employees received a total wage and salary income of \$4,113.8 billion. Within this total, wages and salaries in the goods-producing industries accounted for \$1,156.3 billion, of which manufacturing accounted for \$819 billion. The most recent available data are for September 2004. They show total wage and salary income of \$4,450 billion. But within this total, wages earned in the goods-producing industries were down to \$1,042.3 billion, with manufacturing down to \$683.5 billion.

According to these figures, aggregate wage and salary income increased by \$336.2 billion, or 8.2%, during those 44 months. However, this is before inflation. With consumer prices up by more than 10% over this period, America's working population has clearly not taken part in the economy's recovery at all. GDP, by the way, rose 20.2% in current dollars and 10.8% in real terms during that period.

NO SILVER LINING

So much for the past. The paramount new question about the U.S. economy is, of course, whether the conditions for employment and income growth are significantly improving or deteriorating. As to employment, the official monthly employment reports show an overall increase by 1.7 million from its low in 2002. Could this be the beginning of the indispensable major recovery in employment and income growth?

Meticulous analysis of details and of the underlying macroeconomic conditions leads us to the definite conclusion that the necessary dynamics for a sustained turnaround in employment and income growth are grossly lacking. Rather, they are deteriorating.

First, we question the reliability of the reported employment figures. More than half of the increase has come from the statistical artifice of the "net birth/death ratio," which we regard as a highly dubious device. *Second*, job quality has sharply deteriorated: The losses have been completely in high-paying, full-time manufacturing jobs, while the job gains have overwhelmingly taken place in low-paying, part-time service jobs. And *third*, the wage rate growth of 2.5% keeps lagging the 3.2% growth of consumer price inflation.

In summary, the widely held view that consumer spending is increasingly supported by gains in real wage and salary income has no foundation. Since 2000, consumption has grown despite the weakness in aggregate wage and salary income mainly for two reasons: unprecedented consumer borrowing and unprecedented income creation through the government's soaring budget deficits. But as to the latter, a drastic change for the worse has started with a vengeance.

SLUMPING INCOME GROWTH

There seems to be little recognition of the fact that fiscal income creation literally collapsed in the third quarter. The following monthly numbers illustrate the dramatic change:

CHANGES IN DISPOSABLE PERSONAL INCOME (IN \$ BILLIONS)								
	FEB. '04	MARCH '04	APRIL '04	MAY '04	JUNE '04	JULY '04	AUG. '04	SEPT. '04
IN CURRENT DOLLARS	38.2	36.3	43.8	42.4	21.0	8.6	20.0	9.0
IN CHAINED DOLLARS	15.4	9.4	29.5	9.5	0.5	11.1	18.0	1.9

Source: Bureau of Economic Analysis, Personal Income and Outlays

There is an obvious drastic break in disposable income growth from May to June and the following months. For some time, it has been a foregone conclusion for us that consumer income growth would sharply slow once the tax cuts faded. After a comprehensive analysis of spending and income flows in the economy between private households and the other three main sectors (government, business and foreign), we realize that the consumer's income flow is being squeezed from all sides.

The main source of consumer income is wages and salaries earned from employment. But this source has badly languished in the past few years. To contain the damage, both the government and Federal Reserve stepped in with aggressive countermeasures, providing easy borrowing and spending power through the soaring budget deficit and the implementation of the housing bubble, offering the opportunity for massive equity extraction.

There is, though, an important difference between the two. The housing bubble adds to the purchasing power of consumers by debt creation. The government's deficit bubble works through income creation. Instead, the government incurs the debts. Swinging from a surplus of \$236.4 billion in 2000 to a deficit of \$374.8 billion in 2003, this created a net income flow of \$611.2 billion from the government to the private sector, shared by businesses and private households. We call it fiscal income creation.

Now comes the snag: This fiscal income creation has drastically slowed in the second half of 2004 because the growth of the government's deficit has slowed sharply, reflecting the absence of new tax cuts.

It was, of course, hoped that the prodigious monetary and fiscal stimulus would spawn sharply higher capital spending and hiring on the part of businesses, thus taking over the necessary income creation from the government and central bank. The fact is that the desired traction has failed miserably. This has a precise measure in the so-called financing gap of the business sector.

This aggregate results from comparing the changes in business capital expenditures with changes in the sum of available internal funds from depreciations and retained profits. It is positive for the economy and private households when business capital expenditures exceed the flow of internal funds, as they did in 2000 by \$308.9 billion.

Since the second quarter of 2003, the reverse has been happening. For the first time in the postwar period, business net fixed investment is falling short of cash flow from depreciations and retained earnings. While capital spending has recovered from its low of \$770.7 billion in 2002, it still lags its 2000 peak of \$928.5 billion. The flow of depreciations, on the other hand, has soared from \$683.8 billion to around \$950 billion lately. With retained profits also rising, corporations have been amassing liquidity. Paradoxically, businesses are saving, using the money mostly for the purchase of financial assets and their own stock.

The single biggest negative for profit and income creation in the U.S. economy, though, is the endlessly soaring current account deficit. It implies that spending on goods and services is increasingly diverted from domestic to foreign producers, which implicitly diminishes profits, employment and associated income creation in the United States.

In essence, this outsized external deficit imposes a permanent massive income and liquidity drain on the U.S. economy. Oddly, this drain has sharply accelerated during 2004, with an increase by \$166 billion at annual rate, as against \$25 billion in 2003.

In fact, the money that exits the U.S. economy through the current account promptly returns through the capital account. But it is an illusion to believe that the two flows offset each other. The outflow through the trade gap depletes national income. The return flow through the capital account — purchasing U.S. financial assets or existing factories — bloats the financial circulation, but adds nothing to national income.

In all, we see a serious deterioration in the U.S. economy on three fronts: *first*, the drastic decline in fiscal income and profit creation; *second*, grossly lagging business investment; and *third*, the big and growing drain of the U.S. trade deficit on domestic incomes.

Meanwhile, it is generally accepted that the U.S. economic recovery will only survive if sustained strong business capital investment takes over from consumer borrowing as the engine of growth. Investment has rebounded, yes, but compared to past business cycles, it remains dismally weak — far too weak to lead the economy's further recovery. Recent strength in business investment is partly attributable to the 50% depreciation tax break, requiring that the new equipment be installed by year-end.

THE DELUSIVE AGGREGATE

It appears that the persistent weakness in business investment and hiring is a puzzle for many, if not most, American economists observing, on the other hand, booming profits. Indeed, the statistics of the Bureau of Economic Analysis show one of the steepest increases in "total" profits since 2000, from \$817.9 billion to \$1,173.9 billion — that is, by \$356 billion, or 43.5%. Admittedly, this rise looks exciting.

To our amazement, most economists readily accept these numbers as another marvelous new feature of the U.S. economy. With the same readiness, it is attributed to America's famous productivity miracle, supposedly achieved through the general corporate cost-cutting binge.

Considering the economy's persistent subpar growth, this sudden profit boom was an absurdity for us at first sight, requiring a closer look. Actually, we immediately suspected two main causes: *first*, big "inventory profits" from soaring commodity prices; and *second*, soaring financial profits from rampant financial speculation (the carry trade). The two, indeed, are the true explanation.

As a matter of fact, we believe only what, in our view, has a reasonable explanation. America's prolonged productivity miracle definitely lacks any such explanation. It used to be a truism for economists that productivity growth derives mainly from investment and innovation. If America had booming capital investment, we could believe in strong productivity growth. But with zero savings, record-low net investment and booming consumption, we simply cannot.

As to innovation as a potential source of productivity growth, we do not think that computers still rank as a great new innovation. Actually, we never did. Their importance has always been grossly overrated. Frankly speaking, it continues to amaze us how uncritically the great majority of economists accept everything that the government statisticians in America and Fed chief Alan Greenspan dish out to them.

There are easy ways to create the semblance of a productivity miracle: creative measurement of inflation rates and hours worked. It is no longer a secret that the Bureau of Labor Statistics is unusually creative in this respect.

Returning to the question of profit performance, we feel it necessary to stress that changes in the aggregate become meaningless when its parts extremely diverge, and that happens to be very much the case in the U.S. economy.

While total profits have soared by 43% since 2000, the most important profits — those of the manufacturing sector — have plummeted by 35%. Producers of goods in the United States are facing an ongoing profit disaster that gives them every reason not to invest. The worst performer by far, according to the National Income and Product Accounts, is the "computer and electronic products" sector, producing nothing but heavy losses since 2000.

DISASTROUS RESOURCE ALLOCATION

For years on end, we have explained and warned in this letter that the soaring U.S. trade deficit is a ruthless killer of profits, employment and incomes in the U.S. economy. American policymakers and economists have been notoriously blind to these damages mainly for two reasons: One is a dogmatic conviction that international trade is of mutual benefit to all parties under all circumstances, and the other is America's apparently excellent growth and employment performance over the past several years.

The general complacency starts with the argument that the trade deficit is primarily caused by foreign investors, who are eager to buy all kinds of U.S. assets, offering the highest and safest returns in the world. The rising dollar, then, boosts imports relative to exports. Thus regarding the trade deficit as an automatic offspring of capital inflows, a constant balance between the two is taken for granted. As to the effects of the trade deficit on the U.S. economy, the consensus sees nothing but benefits, pointing to lower interest rates from the capital inflows and lower inflation rates from the import surplus.

It is an unbelievably superficial argument without any trace of macroeconomic analysis. In essence, an external deficit primarily reflects an excess of domestic spending over domestic output. This raises two crucial questions.

The first one: How can U.S. domestic spending persistently exceed its domestic output? The brief answer: through preposterous credit excess in relation to near-zero domestic saving. Next: What is the capital inflow financing in the United States — consumption or investment?

On this latter question, we have repeatedly quoted in past letters a reputed English economist of the 1930s, Joan Robinson: "*Whether this is a good bargain or not depends upon the nature of the use to which the capital inflows*

are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin."

What, then, are the huge capital inflows financing in the United States? Over the nearly four years from 2000 to the third quarter of 2004, private consumption in the United States has accounted for 86.2% of real GDP growth, sharply up from a long-term average of less than 70%. Government spending contributed another 21.7%. Nonresidential fixed investment was flat.

In short, the domestic counterpart to the huge trade deficit and the associated U.S. capital inflows is an unprecedented excess of consumption over production.

THE U.S. TRADE DEFICIT FUELS AN INTERNATIONAL CREDIT DELUGE

Let us return to the first principles of foreign trade. David Ricardo (1772–1823) was the most influential advocate of the mutual benefits of free trade, swaying public opinion in England in favor of trade liberalization. Today, he is the icon of American economists postulating the unmitigated mutual benefits of free international trade.

Listening to these economists, Ricardo must be turning in his grave. What these free trade apostles completely fail to see is that flagrant differences in global monetary conditions between then and now forbid any comparison. In Ricardo's time, global monetary conditions — a de facto gold standard — did not allow the emergence of significant trade deficits. There was nobody to do the lending. In the same vein, the gold standard made internal credit excesses impossible. Also important, consumer credit did not exist. Balanced trade implied balanced benefits.

Even under the Bretton Woods system, greater trade imbalances were virtually impossible for two reasons: *First*, the currency markets used to react sorely even to very moderate deteriorations in a country's trade balance, forcing the central banks to tighten their reins; and *second*, central banks were entitled to demand gold payments at a fixed price of \$35 per ounce from the U.S. Treasury — which the French, in particular, did.

This system changed radically in 1973, when President Nixon cut the dollar's peg to gold. Implicitly, the existing fixed exchange rate system had to be abolished in favor of flexible exchange rates. That was the theory. In practice, many central banks decided to prevent any rise of their currency against the dollar by interventions in the currency market. The cause of dollar's chronic weakness in the 1960s and '70s, by the way, was capital outflows in excess of a trade surplus. Today's chronic U.S. trade deficit emerged a decade later.

Until the late 1960s, the total international reserves of central banks had hovered well below \$100 billion. At end-2003, they exceeded \$3,000 billion, of which two-thirds were in dollars. By far the steepest jump in these reserves occurred in the three years before 2003, with \$907 billion altogether. With China and Japan as the main buyers, Asian central banks virtually bought the whole amount.

But dollar purchases of central banks have far-reaching monetary implications. Particularly since 1997, soaring U.S. trade deficits and soaring central bank interventions flooded the world with dollar liquidity. Buying dollars, a foreign central bank credits its commercial banks with deposits on its account, generally known as reserves, or high-powered money. As the commercial banks face rising reserves, this sets off the famous process of credit excess, fueling asset and spending bubbles in the surplus countries.

GENERATIONAL IRRESPONSIBILITY

Asia has been booming on the back of the credit excesses, propelled by the large dollar purchases by the central banks. But the resulting great spending excess in these countries is overwhelmingly in building and industrial investment, which, over time, ends in over investment and malinvestment. In striking contrast, America's persistent great spending excess is in private consumption.

Quite a few American economists seem to think that overproduction in Asia and overconsumption in the United

States, taken together, make a perfect, sustainable balance between the two areas. The indispensable condition, of course, is that the Asians never relent in financing the American trade deficit, whatever its size. Some economists have hailed it as the new Bretton Woods system, with overconsuming Americans and overproducing Asians happily united under the dollar standard.

Trying to prove the sustainability of this pattern, Harvard professor Richard Cooper recently wrote in *Financial Times*: *"Is it inconceivable in today's increasingly globalized world that savers will want to put 10–15% of their savings into the U.S. economy, a share that decreases over time? The large and rapidly growing pool of savings in China and India have hardly been tapped, bottled up by exchange controls. Investment opportunities in the U.S. economy would be highly attractive to many newly wealthy Chinese and Indians: \$500 billion a year in net private foreign investment may actually be on the short side. In periods when such investment in the United States falls short of \$500 billion, official investment in the form of reserve accumulation will fill the gap as it has done in the past two years."*

Cooper was kind enough to spell out the hard facts behind the popular, though vague, perception that America's huge trade deficit is sustainable. In the late 1990s, it was mainly the stupid Europeans and Japanese who financed American overconsumption. Since the plunging dollar is devastating their wealth acquired in the United States, the poorest yet highest-saving countries in the world — China and India — now need to take over.

Reading this article and many others like it, what strikes us is the unbelievably narrow focus of considerations. There is no understanding at all that America, by running down its savings and investments and piling up unprecedented foreign indebtedness, is boosting its present living standard at the expense of its children's living standard — who inherit from their parents a depleted capital stock and a mountain of foreign debts. For us, it is generational irresponsibility.

In reality, we suspect something else. Many Americans need such heavy borrowing just to maintain their moderate living standard. America's trumpeted great prosperity, based mainly on inflating asset prices, is another blatant illusion.

THE MYTH OF ATTRACTIVE DOLLAR ASSETS

The badly flawed consensus thinking about the implications of sustained large U.S. capital inflow starts with the error that U.S. assets are uniquely attractive to foreign investors. The reality is that U.S. investors are earning far higher returns on their assets in Europe and Asia than foreign investors do on their U.S. assets. European firms and investors who invested heavily in the United States during the "new paradigm" years in the late 1990s are still smarting from horrendous losses. The DaimlerChrysler disaster is by no means an isolated case.

As to U.S. bond yields, they are just marginally above euro yields, but considerably below the yields obtainable in emerging countries. What is more, after inflation, they are the lowest in the world. A falling dollar is, of course, a virtually prohibitive deterrent to foreign bond purchases. In fact, it might induce selling.

This leaves the central banks of Asian surplus countries as the potential buyers of last resort for the dollar, unwanted by private investors. They did heavy dollar buying in 2003 and in early 2004, but never forget, the dollar purchases by the central banks have a heavy price in turning healthy economies into sickly bubble economies.

ANOTHER MYTH: MUTUAL TRADE BENEFITS

The sustainability of the U.S. capital inflows is, actually, the totally wrong question to ask from the American point of view. Far more important is another question concerning the effects of the trade deficit on the U.S. economy, in particular on employment and income creation. We find that the dogmatic belief in the mutual benefit of foreign trade has stifled any reasonable discussion in this respect.

The benefits for the surplus countries are obvious. Exports in excess of imports create higher employment, higher

profits and higher incomes. But what are the benefits to the United States? Frankly speaking, we do not see any true benefit of a trade deficit. What the American "mutual-benefit" apostles fail to see is that a balance in benefits essentially presupposes a balance in the underlying trade, as was the rule in Ricardo's time.

Yet there is a widespread view that the flood of cheap imports, by keeping a lid on U.S. inflation and wage pressures, fosters lower interest rates, which tend to spur economic growth.

For us, both effects are not beneficial at all, because the imports implicitly distort both inflation rates and interest rates to the downside. In essence, the lower inflation rates allow a looser monetary policy than domestic conditions justify. For Greenspan and many others wanting the loosest possible monetary policy, this was certainly a highly esteemed effect of the trade deficit. For us, it is insane.

Nobody seems to realize the enormous damages that the egregious trade deficit has inflicted on the U.S. economy. Indisputably, it diverts U.S. demand from domestic producers to foreign producers, and indisputably, too, this implies an equivalent diversion of employment and associated income creation from the United States to these countries. That is the manifest direct damage of the trade deficit to the U.S. economy, the obvious main victim being the manufacturing sector, with horrendous job and income losses.

Blinded by the dogma of compelling mutual benefits, policymakers, economists, investors and the public in America flatly refuse to see this disastrous causal connection. The alternative explanation is that America's extremely poor job performance has its main cause in the highly desirable high rate of productivity growth.

It is a convenient but foolish explanation, reminding us of the early days of industrialization, when people destroyed machinery for fear of unemployment. For us, productivity growth that destroys millions of jobs is definitely suspect as a mirage. Historically, strong productivity growth has always coincided with strong capital investment involving, in turn, strong employment growth in the capital goods industries.

That is presently, of course, precisely the missing link in the U.S. economic recovery. (As an aside, in a healthy economy with adequate savings, cutting labor costs generally takes place through investment, not through firing.)

The job losses from the soaring trade deficit have always been there. But they did not show up in the aggregate for many years because the booming economy — driven by extremely loose monetary policy — created sufficient alternative jobs. But this alternative job creation has drastically abated since 2000, and the soaring trade deficit's damage to manufacturing is now surfacing in full force.

WHEN THE CARRY TRADE BUBBLE IN BONDS BURSTS...

Having said this, we hasten to add that the U.S. trade deficit must be seen as one imbalance among several others, whether zero or even negative national savings, a soaring budget deficit, record-low net capital investment or sky-high consumer debt. They all derive from the same underlying key cause: unprecedented credit excesses that have boosted consumption for years at the expense of capital formation.

What governs the U.S. trade deficit is not the law of "comparative advantages," but the careless depletion of domestic saving and investment resources though policies that have recklessly bolstered consumption. Essentially, employment creation through capital investment is out. Putting it bluntly, the U.S. trade deficit, like all other imbalances, reflects a grossly skewed resource allocation toward consumption.

To American economists, this idea that over time, excessive consumer spending leads to recession and worse by crowding out capital investment may seem preposterous. Widely unknown, it happens to be the central idea that F.A. von Hayek developed in his famous lectures at the London School of Economics in 1931.

In essence, he explained in great detail that an increase in consumer demand at the expense of saving will inevitably lead to a scarcity of capital, which forces a "*shortening in the process of production*" and so causes

depression. Putting it in simpler parlance: Excessive consumption inevitably crowds out business investment. As a share of GDP, consumption in the United States is presently excessive as never before. And it keeps worsening.

Assessing the U.S. economy's prospects, it also has to be realized that the bubble-driven consumer spending boom represents artificial, unsustainable demand. Apocalypse will follow when the housing bubble bursts — which is sure to happen in the near future.

As the *Boston Herald* recently reported: "[Stephen] Roach met select groups of fund managers downtown last week, including a group at Fidelity. His prediction: America has no better than a 10% chance of avoiding economic 'Armageddon'... Roach's argument is that America's record trade deficit means the dollar will keep falling. To keep foreigners buying T-bills and prevent a resulting rise in inflation, Federal Reserve Chairman Alan Greenspan will be forced to raise interest rates further and faster than he wants. The result: U.S. consumers, in debt up to their eyeballs, will get pounded."

We could not agree more. Our particular nightmare is that the huge carry trade bubble in bonds will inevitably burst in this process. A fire sale of bonds in unimaginable proportions would begin, with bond prices crashing and yields soaring. With the prices of housing, stocks and bonds crashing, the entire U.S. financial system would be at risk.

THE U.S. ECONOMY'S TWO KEY PROBLEMS

It is typically argued that the U.S. economy is importing too much in comparison to exports. Superficially, that is true. Yet on closer look, it is a mistaken perception. Compared to other industrialized countries, U.S. imports are very low as a ratio of GDP. The true key problem is abysmally low goods exports, accounting lately for barely 7% of nominal GDP. This compares, by the way, with a German goods export ratio of 35% of GDP.

The next implicit question is the cause or causes of this extremely low U.S. export ratio. The answer is strikingly obvious. It is precisely the same cause that chokes productive capital investment — the progressive shift in the allocation of available domestic resources away from capital formation through saving and investment in plant and equipment and toward immediate consumption.

That is the supply-side problem. Yet there is a demand-side problem, too. Greenspan and others like to boast that America is creating growing demand for the rest of the world. The ugly truth, rather, is that U.S. monetary policy has been excessively loose in relation to potential domestic output, because Greenspan has wanted maximum economic growth for years. But lacking domestic output capacity to meet the soaring domestic demand, an increasing share of the demand creation from monetary excess exited to foreign producers, resulting in the huge U.S. trade deficit.

It is a flagrant policy failure that has created a monstrous, unsustainable imbalance, both domestically in the United States and globally. However, for years, American policymakers and economists have glorified this deficit as America's great contribution to world economic growth. But the day of reckoning is rapidly approaching.

WHEN THE CURE SEEMS WORSE THAN THE DISEASE

The other day, we read from a generally reasonable economist that the cure for the U.S. trade deficit would be worse than the disease. Looking at the next two to three years, we fully agree and hasten to add that the same is equally true of all the other U.S. imbalances.

The return to healthy economic growth with adequate capital formation will need, among other things, a return to national savings of at least 5–6% of GDP, from close to zero presently. There should be no illusion, however: Even if this adjustment did occur quite gradually over 2–3 years, the U.S. economy would nevertheless slide into its deepest postwar recession, because this would imply sharply slower consumer spending. Does this, indeed, mean that the disease is preferable to the cure, as the economist suggests?

We think American economic policy is facing a horrible dilemma. Securing healthy, sustainable economic

growth again requires the return to a macroeconomic pattern of consumption, saving and investment that can prevail in the long run, representing the so-called adjustment process. But given the enormous size of the existing imbalances, this implies enormous risks and enormous pain.

Yet nothing of this kind is happening. Rather, a sustained "deluge" of credit keeps worsening the boom-related imbalances. Nothing like this has ever happened in history, as Asian central banks, desperately wanting to prevent an appreciation of their currency, put their earned dollars back into the United States.

Many in America are hailing this as the great advantage of their country. They should realize that this is the road to ruin. The important negative point to see is that the longer the imbalances are allowed to fester, the more unmanageable and costly the inevitable adjustment will become.

A NEW ILLUSION: THE FALLING DOLLAR

In his recent speech in Berlin, Greenspan was amazingly frank about the *"increasingly less tenable U.S. current account deficit,"* suggesting that foreign investors would eventually reach a limit in their desire to finance the deficit and diversify into other currencies or demand higher U.S. interest rates.

In essence, he expressed the new consensus view in America that the dollar has to bear the brunt of reducing the U.S. current account deficit. Clearly, American policymakers want a lower dollar, apparently entertaining strong hopes that this will take care of the U.S. trade deficit, and we suspect that they regard it as an easy solution for this problem.

We doubt first of all that it is a solution at all. Such expectations essentially presuppose that an overvalued dollar is the main cause of the U.S. trade deficit. This is bogus. By the measure of purchasing power, the dollar was hardly out of line with the currencies of other industrialized countries.

The favorite American explanation for the huge and growing trade deficit is the U.S. economy's superior growth performance and lacking foreign demand. But the Chinese economy is growing much faster than the U.S. economy yet has a big trade surplus. So had Japan in the late 1980s, and so had Germany in the decades to the late 1970s.

This explanation of the trade deficit with superior U.S. GDP growth is another illusion among many others. What crucially matters for a country's trade balance is not its economy's growth rate, but its internal resource allocation between consumption and investment. High rates of saving and investment make for a strong trade balance, while high rates of consumption make for a weak trade balance. America's unusually poor trade performance reflects extremely poor rates of saving and investment. Overconsuming and undersaving America lacks the necessary capital stock to increase its exports.

These observations essentially raise the question of whether or not the falling dollar is prone to rebalance the U.S. economy's foreign trade. It is argued that the dollar's slide did a great job slashing the U.S. trade deficit from 1989–1993. This is true, but was it really the falling dollar that did it? It actually happened against the backdrop of a sharp slowdown in credit growth and a recession in 1991.

During the four years 1989–93, total credit in the United States — financial and nonfinancial — grew by a cumulative \$3,255 billion, or \$819 billion per year. In flagrant contrast, during the four years to mid-2004, overall credit grew virtually three times as fast, by \$2.4 trillion per year, and there is no letup in sight. Drawing on past experience, a fall of the dollar, however steep, will hardly make a dent in the trade deficit by itself.

Lowering the trade deficit first requires a lowering of domestic demand growth, and a drastic shift in resource allocation away from consumption and toward investment in the longer run. A mere fall of the dollar is definitely no solution. Yet we very much doubt that policymakers in Washington have the slightest intention to implement or foster the necessary changes in demand and resource allocation with policy measures.

A DISTURBING OUTLOOK

While the consensus holds that after a soft patch in 2004, economic growth and the stock market will soon surprise again on the upside, we see overwhelming signs for a surprisingly sharp slowdown of the U.S. economy. Unmistakably, the bulk of statistical data and survey results remains plainly on the negative side.

Yet our main adverse considerations are organic in nature. One, for reasons previously explained, is the actual sharp downturn in fiscal income creation; the other is the apparently definite failure of the past massive monetary and fiscal stimulus to revive income creation through significant employment growth. The latter turns out to have been nothing more than a palliative that merely prolonged and worsened the existing imbalances.

The housing bubble and the opportunity it created for profligate "home equity extraction" was the most important artificial prop supporting consumer spending. There is growing evidence that this bubble is finally in its last gasp.

It should be clear that a burst of the housing bubble would have disastrous implications, not only for millions of overindebted consumers, but also for the grossly overstretched lending institutions. Consider that about 60% of the U.S. commercial banks' earning assets are mortgage related, compared to 30% in the mid-1980s. For the numerous nonbank lenders, the share of mortgage credit is closer to 100% of total assets. Assessing the potential for collateral damage, keep in mind that the gains in prosperity in the United States in the past have been built entirely on negative short-term interest rates.

A TOUGH TIME AHEAD FOR THE FED

What about the risks for the dollar and the markets? In short, they are frightening. The most frightening risk is that the dollar's fall gets out of control. Superficially, the dollar's steep fall in the 1980s and '90s may seem encouraging in this respect.

However, there is something that makes all the difference between then and now. When the dollar's decline started in 1985, dollar assets held by foreigners were close to zero. This time, they are close to \$9,000 billion, one-third of which is held by central banks.

The dollar's further behavior will largely depend on the flow of news about the U.S. economy. Bad economic news is bad for the dollar. For the reasons explained earlier, we expect very bad news that will shatter the hollow optimism about the economy and the stock market. While economic growth is sharply decelerating, inflation is accelerating, a main reason for this being an accelerating rise in import prices.

In such circumstances, the Fed will face a Catch-22. With CPI inflation above 3% at annual rate and a falling dollar, a new easing of monetary policy is absolutely impossible. Rather, the market will expect the Fed to continue its rate hikes. But doing so, it would prick the carry trade bubble in bonds with disastrous effects, first on the bond market and then on the economy.

A steeper fall of the dollar, just by itself, might please U.S. policymakers. Unfortunately, it is bound to have a variety of harmful effects — in particular on psychology, inflation rates and interest rates. It may finally dawn on people that due to the horrendous magnitude of the existing imbalances, the development in the economy and the markets is out of control.

HOW FAST, HOW FAR?

After many months of stability during 2004, the dollar has turned south all of a sudden. Observing the U.S. economy's deteriorating performance since early this year, its protracted stability surprised us. Now its sudden slide perfectly concurs with our dismal expectations for the U.S. economy in 2005. Yet the abrupt general bearishness of dollar forecasts strikes us as ominous in comparison with the highly bullish consensus growth forecasts for the economy (those for Europe are distinctly bearish).

Let us try to make sense of these contradictions. Over time, we have learned the hard way that two different things govern the behavior of markets: *first*, the objective facts; and *second*, the general perception of the facts. They can differ like black and white.

Our opinion about the economic situation in the United States has been and remains diametrically at variance with the optimistic consensus view that discarded the economy's slowdown as a "soft patch" due to the rising oil price. In our view, the economy is rapidly losing steam because prior aggressive monetary and fiscal stimulation has largely spent itself, while having failed to initiate the desired self-sustaining investment recovery. Moreover, we hold a strong opinion that the existing outrageous imbalances and structural dislocations in the economy make a normal, sustainable economic recovery flatly impossible.

CONCLUSIONS

Pondering the causes and implications of the dollar's sudden plunge, it ought to be recalled that global currency experts were overwhelmingly forecasting a strong dollar and a weak euro, commensurate with expected strong economic growth in the United States and sluggish economic growth in Europe.

There rules a perception in the markets that the U.S. economy is fundamentally strong and, in addition, vastly superior to that of Europe in resilience and flexibility. All that is sheer nonsense. Due to years of unimaginable credit excesses and resulting monumental imbalances, the U.S. economy is highly vulnerable to a sudden downturn. It is, in fact, in worse shape than in 2000.

U.S. policymakers and economists are hailing the dollar's fall as a boon for exports, employment and profits. They fail to realize that the consumer borrowing and spending excesses of the past few years have grossly depleted the economy of available resources for sharply higher exports. A plummeting dollar does nothing at all to offset the profound structural shortfall of savings and capital formation. Rather, it fuels inflation.

Remarkably, the dollar has plummeted despite highly optimistic expectations about the economy's outlook as reflected in stellar growth forecasts. It is our assumption that increasingly bad economic news will shake this overconfidence and speed up the dollar's decline.

For reasons already explained, we expect that sharply weaker consumer spending will soon distinctly slow the U.S. economy. Two events in particular are putting the brakes on economic growth: *first*, the full stop of the income creation through tax cuts; and *second*, the waning of the housing and mortgage refinancing booms.

The risks are frightening.



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